Reconsidering the Federal Reserve Model for Pension Plan Management

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Topics

- Models, strategies and processes
- Institutional investor goals
- Evolution of investment models
- Review of academic studies
- Diversification, diversification, diversification
- Level 2 diversification
- The federal reserve model
- How does it work?
Models, Strategies and Processes

- Government and legal structure
- Production models
  - Olds then ford revolutionized production
- Organizational design
  - Hierarchical pyramid
  - Flat
  - Employee empowerment
  - Compensation strategies
- Labor and management organizations
- Investment strategies and models
Institutional Investor Goals:

- Consistently meet or beat return objective
- Prudently manage risk
- Minimize costs
- Ensure proper governance and best practices
- Minimize conflicts of interest
- Maximize transparency
- Minimize fiduciary liability
- Minimize time commitment

What Model Best Accomplishes These Goals?
Investment Models Keep Evolving

- Bond Only
- Balanced “60/40”
- Core/Satellite
- Multi-Specialty
- Multi-Multi

Inv. Consultant Optional | Investment Consultant(s) Needed

- Single Investment Manager
- Multiple Investment Managers
Bond Only Model

Plan Sponsor

Investment Policy Statement

Fixed Income Manager
Balanced or “60/40” Model

Plan Sponsor

Investment Policy Statement

Balanced Manager
Core/Satellite Model

Plan Sponsor

Investment Policy Statement

Chief Inv. Officer/Investment Consultant

- Small Cap Blend
- Int’l Equity
- Balanced Manager
- High Yield
- Real Estate
Multi-Specialty Model

Plan Sponsor

Investment Policy Statement

Chief Inv. Officer/Investment Consultant

Investment Committee (optional)

Equity

Large Growth
Large Value
Mid Cap Blend
Small Cap Blend
Int’l Equity

Fixed Income

Core Fixed
High Yield
Int’l Bonds

Alternatives

Real Estate
Hedge Funds
Commmodities
GTAA
Priv. Equity

15B-9
Multi-Multi Model

Plan Sponsor

Investment Policy Statement

Chief Inv. Officer/ “Generalist Consultant”

Investment Committee (optional)

Equity Investment Consultant

Large Growth
Large Value
Mid Cap Blend
Small Cap Blend
Int’l Equity

Fixed Income Investment Consultant

Core Fixed
High Yield
Int’l Bonds

Alternatives Investment Consultant

Real Estate
GTAA
Hedge Funds
Commodities
Priv. Equity

15B-10
This Evolution Has Meant:

- Greater complexity
- Higher costs
- Difficulty in monitoring
- Less transparency
- More conflicts of interest
- More administrative costs
- Longer meetings
- More and better diversification? Yes and no

*Do these factors suggest a better chance for success?*
Studies Have Concluded . . .

“. . .we find no evidence that these recommendations add value to plan sponsors.”

Picking Winners? Investment Consultants’ Recommendations of Fund Managers

Tim Jenkinson, Howard Jones and Jose Vicente Martinez
Oxford University, 2013
Studies Have Concluded. . .

“Excess returns after terminations are typically indistinguishable from zero but in some cases positive. In a sample of round-trip firing and hiring decisions, we find that if plan sponsors had stayed with fired investment managers, their excess returns would be no different from those delivered by newly hired managers. We uncover significant variation in pre- and post-hiring and firing returns that is related to plan sponsor characteristics.”

The Selection and Termination of Investment Management Firms by Plan Sponsors
Amit Goyal and Sunil Wahal
Journal of Finance, 2008
Studies Have Concluded...

“Much like individual investors who switch mutual funds at the wrong time, institutional investors do not appear to create value from their investment decisions.”

Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors
Scott D. Stewart, CFA, John J. Neumann, Christopher R. Knittel, and Jeffrey Heisler, CFA
How Do We Defend Against the Risk of Poor Decisions?

- Diversification! Diversification! Diversification!
  - Asset class diversification
  - Active manager diversification
  - Portfolio holdings diversification
As of December 31, 2013:

By adding a 40% bond allocation, the portfolio has better downside protection and risk—adjusted returns, i.e., “more efficient.”

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<thead>
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Active Manager Diversification

A portfolio with a single active manager can be “feast or famine.” Diversifying active manager risk can smooth the ride.

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<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
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<td>3.0</td>
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<td>4.4</td>
<td>6.9</td>
<td>5.6</td>
<td>1.56</td>
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</table>
A portfolio holding just a single stock will have the risk and return characteristics of that stock. More stocks means more market-like risk and returns.
Total Portfolio Diversification

- The Multi-Specialty and Multi-Multi Models Diversify the Following:
  - Asset Allocation Risk
  - Active Manager Risk
  - Portfolio Holdings Risk

Has the Plan Diversified its Major Sources of Risk?

*Hint: Think Back to the Studies Cited*
Level 2 Diversification Is **Missing**

**Level 1**
- Plan Design & Process
- Risk & Return Goals
- Actuarial Rates/Tables
- Benefits Rates/Changes
- Projected Cash Flows

**Plan Sponsor & Actuary**

**Level 2**
- Asset Allocation- Strategic & Tactical Manager Selection
- Rebalancing

**Consultant**

**Level 3**
- Portfolio-level Buys & Sells

**Manager**
Level 2 Diversification Is Missing

- Level 2 decisions concern:
  - Asset allocation
  - Tactical asset allocation
  - Manager selection
  - Rebalancing

- Level 2 diversification can be described as:
  - “Thought diversification”
  - “Strategy diversification”
  - “Execution diversification”
Where Are Level 2 Decisions Made?

Plan Sponsor

Investment Policy Statement

Chief Inv. Officer/Investment Consultant

Investment Committee (optional)

Equity
- Large Growth
- Large Value
- Mid Cap Blend
- Small Cap Blend
- Int’l Equity

Fixed Income
- Core Fixed
- High Yield
- Int’l Bonds

Alternatives
- Real Estate
- Hedge Funds
- Commodities
- GTAA
- Priv. Equity
Where Are Level 2 Decisions Made?

Plan Sponsor

Investment Policy Statement

Chief Inv. Officer/“Generalist Consultant”

Investment Committee (optional)

Equity Investment Consultant

Fixed Income Investment Consultant

Alternatives Investment Consultant

Large Growth

Large Value

Mid Cap Blend

Small Cap Blend

Int’l Equity

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Real Estate

Hedge Funds

Comm. odities

Priv. Equity

Core Fixed

High Yield

Int’l Bonds

Real Estate

Hedge Funds

Comm. odities

Priv. Equity
Is There a Better Way?

- The multi-balanced model AKA federal reserve model offers:
  - Diversification of level 2 decisions
    - Asset allocation
    - Tactical asset allocation
    - Manager selection
    - Rebalancing
  - AND
  - Diversification by portfolio
    - Greater asset allocation diversification
    - Greater active manager diversification
Diversification By Portfolio!

- Each balanced manager becomes its own diversified portfolio. There is now diversification by portfolio!

Balanced Manager D
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Hedge Funds
- Commodities
- Private Equity
- GTAA
Besides gaining level 2 diversification, other benefits include:

- Real time dynamism
- Greater asset class diversification
- Greater manager diversification
- Ease of monitoring
- Lower costs
- Lower fiduciary liability
- Fewer conflicts of interest
- Saves time
Real Time Dynamism

- Each balanced manager can independently react to changes in the financial markets in real time:
  - Asset allocation
  - Rebalancing
  - Tactical asset allocation

- Compare to the multi-specialty model
  - Cumbersome process
  - Delayed implementation
  - Discretionary authority does streamline process
Greater Asset Class Diversification

- Many assets classes have sub-classes
- Difficult to achieve following multi-specialty investment model
  - Can one manager adequately cover an asset class?
    - International equity
    - Commodities
    - Real estate
    - GTAA
    - Hedge funds
- Multi-balanced model brings diversification of thought to asset class strategy
Greater Manager Diversification

- Management styles for large cap managers:
  - Growth
  - Value
  - Blend
  - Aggressive growth
  - Growth at a reasonable price (GARP)
  - Deep value
  - Momentum
  - Concentrated core
  - Quantitative
  - Enhanced index
  - Index

- Multi-balanced model brings diversification of thought to manager style selection strategy
Ease of Monitoring

- Fewer managers = fewer reports
- Interview one manager each quarter
- Manage to same benchmark and objective
  - Add returns and divide by number of managers
  - Annual total plan and manager performance report
    - No benchmark linking
- Same fee schedule
Lower Costs

- Economies of scale or volume pricing
- Lower or no investment consultant fees
- Lower administrative costs
  - Billing
  - Contract review
  - Coordination
  - Meetings
- 20%–40% estimated reduction in fees
  - Depending on size, number of managers, indexing
Lower Fiduciary Liability

- If using a non-discretionary investment consultant, the plan sponsor approves decisions following the advice of just one professional; no level 2 diversification.

- Granting discretionary authority to:
  - Single investment consultant = concentration
  - Multiple balanced managers = diversification

- Can still employ an investment consultant:
  - Oversee multi-balanced model
  - Performance monitor
  - Occasional asset allocation studies
Fewer Conflicts of Interest

- Complexity = job security
- Active managers, not indexing
- Incentive to buy high, and sell low
  - Defensive decision making when non-discretionary
- Reporting
  - Benchmark linking
  - Not tracking fired managers
  - Universe rankings
- Not emotionally invested in process
  - Hands-off increases objectivity
Shorter Meetings

- Fewer reports with annual reporting
  - Consultant
  - Manager
  - Committee meetings
- Fewer searches and studies
  - Managers “on watch”
  - Manager interviews
  - Asset allocation studies
How Does it Work?

- Hire an investment consultant?
  - Implement and oversee multi-balanced model
  - Performance reporting and manager monitoring
  - Asset allocation studies
- Decide on number of balanced managers
  - Total AUM is main criteria
- Craft investment policy statement
  - Broad asset allocation ranges
  - Credit quality limits
  - Leverage limits
- May separate alternative assets
  - Allow balanced managers “liquid” alternatives
- Objective re-balancing policy? (Time or %)
- Objective manager termination policy?
Steps to Implementation

Planning
• Draft New Investment Guidelines
  • Objective and Index
  • Asset Classes and Allocation Ranges
  • Leverage and Credit Quality Limits
• Full-time Consultant?

Hire
• Determine Number of Balanced Managers
• Search, Interview and Hire

Transition
• Hire Transition Manager
• Fund the Balanced Managers

On-Going
• Monitor Managers
• Re-Balance
• Asset Allocation Review
How Does it Work?

Plan Sponsor

Investment Consultant – Performance Monitor

Investment Policy Statement

Asset Allocation
- 30% to 70% Equity
- Small Cap <= 20%
- International <= 30%
- 20% to 80% Fixed Income
- High Yield <= 20%
- International <= 20%
- 0% to 20% Leverage
- No Illiquid Investments
- No Alternatives

Alternatives Manager
- Up to 15% of AUM

Balanced Mgr A
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Balanced Mgr B
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Balanced Mgr C
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Balanced Mgr D
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Alternatives & Illiquid Manager
- Private Equity
- Hedge Funds
- Infrastructure
- Venture Real Estate
- Distressed Credit
How Does it Work?

Plan Sponsor

Investment Consultant
- Performance Monitor

Investment Policy Statement

Investment Consultant
- Generalist

Balanced Mgr A
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Balanced Mgr B
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Balanced Mgr C
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Balanced Mgr D
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
- GTAA

Alternatives & Illiquid Manager
- Private Equity
- Hedge Funds
- Infrastructure
- Venture Real Estate
- Distressed Credit

Asset Allocation
30% to 70% Equity
- Small Cap <= 20%
- International <= 30%
20% to 80% Fixed Income
- High Yield <= 20%
- International <= 20%
0% to 20% Leverage
- No Illiquid Investments
- No Alternatives

Alternatives Manager
Up to 15% of AUM
How Does it Work?

- No consultant—“auto pilot” policies
  - Cash flows dependent on manager AUM
  - Manager terminations can be made objectively
  - Rebalance by time or AUM
  - Asset allocation study every few years, if needed
    - Managers may form committee
  - Annual report from performance monitor
    - Searches done case by case

- Manager options
  - Some passive, some active
  - Foreign- based managers
  - Start with many and consolidate over time
  - Discretionary consultants may be balanced managers
Are There Any Problems?

- **Group think**
  - All balanced managers may go one direction
    - Stress-test the investment guidelines

- **Sub-manager monitoring**
  - Duty of balanced manager to monitor
  - May have independent performance monitor

- **Fee transparency**
  - Disclosures and monitoring
  - Trade execution study
  - Audit fee compliance

Do Potential Negatives Also Exist in Consultant-Centric Models?
We Follow A Risk–Parity Investment Strategy

Plan Sponsor

Investment Consultant (optional or part-time)

Investment Policy Statement

Risk-Parity Manager A
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Hedge Funds
- Commodities
- Private Equity
- GTAA

Risk-Parity Manager B
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Hedge Funds
- Commodities
- Private Equity
- GTAA

Risk-Parity Manager C
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Hedge Funds
- Commodities
- Private Equity
- GTAA

Risk-Parity Manager D
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Hedge Funds
- Commodities
- Private Equity
- GTAA

Investment Committee (optional)
We Index, Can This Model Help?

Plan Sponsor

Investment Policy Statement

Index Manager A
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities

Index Manager B
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities

Index Manager C
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities

Index Manager D
- Large Cap
- Mid Cap
- Small Cap
- International
- Core Fixed
- High Yield
- International Fixed
- Real Estate
- Commodities
The Big Question

- Are the multi-specialty and multi-multi models “broken models?”
  - No level 2 diversification
  - No real time dynamism
  - Dependent on a few key personnel
  - Delayed implementation
  - Conflicts of interest
  - Higher costs
  - Incomplete performance reports

Recall Those Academic Studies
Closing Thoughts

- Institutional investors want it all
  - Consistently meet or beat return objective
  - Prudently manage risk
  - Minimize costs
  - Ensure proper governance and best practices
  - Minimize or eliminate conflicts of interest
  - Maximize transparency
  - Minimize fiduciary liability
  - Minimize time commitment

- Multi-balanced model is a powerful solution
  - Level 2 diversification
  - Real time dynamism
  - Greater asset class diversification
  - Greater active manager diversification
  - Easier to monitor
  - Lower costs
  - Lower fiduciary liability
  - Fewer conflicts of interest
Takeaways

- **Multi- Balanced Model**
  - Multiple Balanced Managers Each Following the Same Broad Guidelines with Discretionary Authority

- **Level 2 Diversification**
  - Diversification of Thought & Strategy for Key Decisions
    - Asset Allocation
    - Manager Selection
    - Rebalancing

- **Steps For Implementation**
  - Planning: Draft Guidelines. Full- time Consultant?
  - Search & Hire Balanced Managers
  - Transition Manager: Multi- Specialty → Multi- Balanced
  - On- going Performance Monitoring and Rebalancing
Questions and Comments

“Doubt is the beginning, not the end, of wisdom.”

~Fortune cookie fortune in my wallet